THE LEGAL NATURE AND IMPACT OF THE INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (BASEL II), AS A COMPONENT OF BANKING SUPERVISION, ON BANKING LAW

by

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MINOR DISSERTATION

Submitted in partial fulfillment of the requirements for the degree

MASTER OF LAWS

in

BANKING LAW

at the

UNIVERSITY OF JOHANNESBURG

SUPERVISOR: PROFESSOR SF DU TOIT

DECEMBER 2010

ABSTRACT

The Basel Capital Accords have been observed and implemented by banks throughout the world, although produced and formulated by a body which possesses no law making authority. Due to a lack of binding force the work of the Basel Committee on Banking Supervision is regarded as recommendations only and implemented and complied with on a voluntary basis. Against the backdrop of the recent global economic crisis and the development of banking supervision, I aim to come to a conclusion as to the nature of the Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), through a comparison between various possibilities of classification. The investigation of the legal nature and possible classification of Basel II is of significance as there is no real certainty regarding its current legal nature, except that it is a non-binding accord considered to be "soft law". A further investigation will be performed on the development of banking supervision in the United States of America, South Africa and the United Kingdom and the impact of Basel II on each of these jurisdictions. A comparative study will be conducted which focuses primarily on the measures of implementation and impact which Basel II has had on the countries under consideration. The role which Basel II played in the recent world economic crisis deserves discussion due to the great impact that was felt by the banking industry on a global level, in particular the role which Basel II possibly played in the economic impacts felt by the United States of America, South Africa and the United Kingdom. By this study I wish to achieve clarity on the role which Basel II plays, its impact on banking law as a whole, as well as its nature.

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CHAPTER 1
INTRODUCTION

1.1 *Background*

As a component of banking supervision, the 1988 Basel Capital Accord and the International Convergence of Capital Measurement and Capital Standards: a Revised Framework (hereafter referred to as the Basel Capital Accords) have been applied and implemented widely in the banking industry as a form of convergence of international banking regulation and have been observed in numerous countries as global best practice in the supervising of banks. The Basel Capital Accords have been seen as extremely influential although regarded as “soft law”, which is non-binding with no formal legal status or authority to bind the countries who subscribe to their principles.

The role of the Basel Committee on Banking Supervision (hereafter referred to as the Basel Committee) is significant within the banking industry globally, having produced significant recommendations on best practice which contributed to the development of banking supervision on an international level. The impact of the International Convergence of Capital Measurement and Capital Standards: a Revised Framework (hereafter referred to as Basel II) can be seen in the wide recognition which the work of the committee has received in the banking industry and in the application and importation of the principles of Basel II into domestic legal systems by banking supervisors. A large majority of banking supervisors have made compliance with the principles of Basel II compulsory within their respective countries, thereby concretising the recommendations.

1.2 *Problem Statement*

Although the Basel Capital Accords have been acknowledged and widely observed throughout the world, not only by banking supervisors of countries who are members of the Basel Committee, the question exists as to what Basel II is, with reference to the contents and nature of its framework.

Consideration of the development of banking supervision globally, with reference to the previous capital accord, and the specific impacts thereof is required in order to arrive at a point of clarity with regard to the nature of Basel II. Consideration of the nature of the Basel II should be done in conjunction with an investigation of the particular development of banking supervision and impact which Basel II has had on the banking industry in various jurisdictions. In particular the United States of America, South Africa and the United Kingdom will be considered.

The banking industry was affected to a great extent by the world economic crisis which commenced in 2007 and Basel II deserves consideration within this context in this minor dissertation. A consideration of the recent world economic crisis will conclude the entire study as a practical analysis of whether Basel II was able to contribute in any way to the effects and economic impacts which were experienced by banks in the United States of America, South Africa and the United Kingdom during this time.

1.3 *Methods and procedures*

The aims of this study will be achieved through consideration of the development of banking supervision and the Basel Capital Accords, the state of banking supervision and the impact of Basel II on the United Kingdom, the United States of America and South Africa, the possible classification of Basel II and finally the role which Basel II played in the impacts felt by the mentioned countries during the world economic crisis.

The development of banking supervision on a global level will be considered with reference to the origin of banking supervision and the Basel Committee, as well as a consideration of each of the Basel Capital Accords (Basel I and Basel II) and their introduction into the world banking industry. This investigation will be concluded by a brief consideration of what the Basel III recommendations will contain when finalised and released for implementation in the future.

The impact of the Basel Capital Accords will be assessed by way of studying the impact of the latest capital framework (Basel II) on the United States of America, South Africa and the United Kingdom through considering the development of banking supervision in each of these jurisdictions.

In order to answer the question which relates to the legal nature of the latest Basel Capital Accord, Basel II, various possibilities of classification will be considered with reference to the validity requirements for each proposed classification and the position of each proposed classification within the law. In particular, the possible classification of Basel II as an agreement, treaty, international trade usage or a new *lex mercatoria* (new law merchant) will be considered. Finally, a comparison will be drawn between the legal nature of Basel II and the Uniform Customs and Practice of Documentary Credits (UCP 600) which applies to the issuing and use of letters of credit.

In light of the recent global economic crisis, the role of Basel II in the impacts which were felt by the United States of America, South Africa and the United Kingdom will be considered.

This minor dissertation will focus on general provisions and principles of Basel II and will not amount to an exposition of specific principals contained therein, except to the extent that such principles require consideration in assessing the nature and impact of Basel II. A detailed study of the specific principles of Basel II falls outside the scope of this minor dissertation.

CHAPTER 2
THE DEVELOPMENT OF BANKING SUPERVISION AND THE BASEL CAPITAL ACCORDS

2.1 *Introduction*

The supervision of banks has become increasingly important over time, especially in light of the development of technology and globalisation. Banks do business with each other internationally making them susceptible to risk due to their monetary exposure to each other. Largely banking supervision has emerged in reaction to the risks which banking institutions are exposed to and represent the attempts of bank supervisors and banks to mitigate and prevent these risks from impacting them to such a great extent that they are declared insolvent.

Banking on an international level is not only confined to large banks but also to smaller banks who have established relations internationally, including banks from developing countries, having the effect that banking operations internationally have become more complicated in terms of supervision and the maintenance of certain required standards.[1] This shows that banking supervision is a discipline which is common to the business of any bank regardless of the size of the institution.

In this chapter the development of banking supervision will be addressed with reference to the various Basel Capital Accords and the establishment of the Basel Committee. Various risks to the banking industry will be identified, with reference to the reasons for their existence as a precursor to considering the measures and procedures put in place to guard against these respective risks. Future developments will be considered in light of the impending release of a further capital framework by the Basel Committee, which amounts to strengthening of capital requirements under Basel II.

[1] Effros *Current Issues Affecting Central Banks* (1994) 331.

The establishment of the Basel Committee, as the institution driving banking supervision globally will be addressed and finally the products of the deliberations of the Basel Committee, Basel I and Basel II up to this point will be considered in light of the major causes for their formulation and application pointing out the major differences between them.

Regulating banks is important to ensure a healthy financial system for stability and growth in any economy. The banking sector is more inclined to suffer crisis than any other sector in an economy, and are highly geared institutions.[2] For this reason the banking industry requires specific and organised supervision and regulation.

2.2 *The development of banking supervision and the Basel Committee on Banking Supervision*

2.2.1 *The Basel Committee on banking supervision*

The Basel Committee on Banking Supervision was initially made up of central-bank Governors of the Group of Ten Countries.[3] It was established in 1974 as a consequence of the failure of Bankhaus Herstatt in West Germany which contributed to significant instability in international currency and the banking market as a whole.[4]

The Basel Committee is neither a national organisation of a specific country nor an official international regulatory agency.[5] It has no legislative authority and the recommendations made by it are merely, recommendations on best practice. The key objective of the Basel Committee is to provide a forum for regular cooperation between members specifically on matters which relate to the supervision of banks and to improve the standards which are implemented by banks on an international level. The committee also identifies areas of poor regulation and risk to move towards a

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2 Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law* 1 25-26.

3 The group of ten or G-10 countries are a group of countries which have agreed to take part in the General Amendments to Borrow (GAB) and include some of the most powerful countries in the world.

4 "The history of the Basel Committee and its Membership" August 2009 http://www.bis.org/bcbs/historypdf (20-9-2010).

5 Tarbert "Rethinking Capital Adequacy: the Basle Accord and the New Framework" 2001 Bus. Law 767 767.

system where there is adequate supervision and where all banks are supervised appropriately internationally.[6]

2.2.2 *Banking Regulation*

Banking regulation and banking supervision are two components which are closely related, banking regulation refers to rules and banking supervision focuses on the enforcement of these rules.[7] However the terms banking regulation and banking supervision are often used to describe the same concept.[8]

Various techniques of prudential regulation have been developed over time involving measures which are aimed at being preventative in nature as well as techniques which are aimed at being protective in nature. Preventative regulatory techniques are typically procedures which aim to prevent a banking crisis by way of reducing the risks which affect banks. Protective regulatory techniques are a basis of support to banks in the event that a banking crisis threatens to manifest.[9]

Taking into accountant the special role which a bank plays as a link between an investor of funds and his investment, and that various risks are unique to the business of banks, a real possibility exists that in the event of a bank failing, money supply to depositors would be placed in real jeopardy. Depositors' money supply can be placed in jeopardy by a number of occurrences which include runs and panic.[10]

Prudential supervision of banks requires that bank supervisors and management structures within banks put into place certain measures and procedures to counter risks which threaten banks and that they make provision for the adaptability of the measures in response to foreseeable eventualities. Supervision also intends to ensure

6 "The history of the Basel Committee and its Membership August 2009 http://www.bis.org/bcbs/historypdf (20-9-2010).

7 Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 315.

8 Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 71 71.

9 Cranston *Principles of Banking Law* (2003) 82.

10 A run on a bank is when a large number of depositors withdraw their deposits within a short period of time of each other, usually when they believe that the bank may be declared insolvent ; Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 71 74.

that constant development of assessment techniques to assess the success of the management structures of banks in their assessment of risks are in place.[11]

What is clear is that the supervision of banks on a prudential level is not only the responsibility of the structure or body which is tasked with ensuring that banking supervision is practiced and adhered to in a country, but that it is also the responsibility of the management structures within banks and even more so in their interest to ensure that effective mechanisms and procedures are in place to ensure that a bank is sufficiently protected against failure. In considering the duty of managers of banks it is of great importance that suitable and competent staff are recruited to achieve this goal.

The good corporate governance within banks is also an aspect which contributes to financial stability.[12] The reason why good corporate governance of banks is important, especially to the structures which are responsible for the supervision of banks, is because the supervision of banks is enhanced by the actions of the board of directors of banks as well as the managers of banks, who are in turn responsible for the implementation and maintenance of prudential supervisory systems and procedures within individual banks.[13]

2.2.3 *Banks versus traditional companies*

Banks play an integral role in all economies of the world, operating payment systems and fulfilling the role as a safe place for depositors to place their funds.[14] The main business of banks is regarded as taking deposits from the general public which are normally repayable on demand. What makes a bank distinguishable from any other companies which trade for profit is the fact that banks lend the deposits made by depositors to other borrowers on another set of terms and conditions which normally would involve a higher interest rate than that repayable on funds deposited by a depositor. The difference between the interest paid to a depositor and that charged to a

[11] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 80.
[12] Mülbert "Corporate Governance of Banks" 2009 *EBOR* 411 429.
[13] Mülbert "Corporate Governance of Banks" 2009 *EBOR* 429.
[14] Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 1.

borrower, is where a bank generates its profit.[15] Although explained in relatively simple terms it must be appreciated that banks have millions of similar transactions of both depositors saving funds and withdrawing funds and on the other hand borrowers who borrow these funds at a particular point in time. The volume of these transactions makes the management of a bank complicated and causes various risks to be associated with the role which a bank plays between the depositors of money and the borrowers of money. This has been the focus of bank supervisors and bankers alike throughout the world. The business of banks is not solely made up of lending deposits, but is expressed as their major function in this context.

Banks can be distinguished from companies due to banks being subject to strict regulations in terms of capital levels and their exposure to risk, as well as in the corporate governance practices which are implemented in order to support the management of risk and capital levels. This shows that the corporate governance frameworks required in banks are markedly different to those of companies.[16]

Banks are institutions in which the level of profit they generate is relative to the lending they do. The balance sheets of banks differ from other corporate entities in that the quality of a loan extended by a bank which should be reflected as an asset on its balance sheet differs from that of an asset on the balance sheet of a company due to the difference between the estimated value of a loan versus a fixed asset or tangible property. Another difference is that banks could be subject to a run. A run can be caused by small depositors, bondholders or by other banks in the market withdrawing their deposits within very short periods of each other and for these reasons banking regulation imposes certain limits or thresholds on the amount of risk which a bank may expose itself to.[17]

[15] Hudson *The Law of Finance* (2009) 729-730.
[16] Mülbert "Corporate Governance of Banks" 2009 *EBOR* 412.
[17] Mülbert "Corporate Governance of Banks" 2009 *EBOR* 421-422.

2.2.4 *Areas of risks for banks*

Banks often fail because of the inaccurate calculation and perception of risks. Risks to banks exist in various forms, namely credit risk, systemic risk, fraud, money laundering, yield risk, market risk, operational risk and management risk.

Credit risk to banks lies in the obligation of a bank to repay the full amount back to a depositor even though the loan which it made with the funds of the depositor were not repaid to it. This type of risk exists to a large extent due to the uncertainty which exists in placing a value on the assets of banks, which are loans. If loans made in terms of deposits are not repaid, it erodes the profits of banks and in some instances to such a severe extent that the bank will experience liquidity problems. Unlike the value of the assets of a bank, the liabilities of a bank are more readily ascertainable. For this reason banks are required to keep a "buffer" of capital available in order to make sure that the funds of depositors can be repaid in the normal course of business and even in circumstances of unexpected losses.[18]

Systemic risk originates from the various relationships and links between banks through a payment system in terms of which banks send payment instructions to other banks during a specific banking day, at the end of which the payment instructions are settled and balanced. In the event that a bank fails to or is not in a financial position to settle its payment obligations at the close of a banking day other banks are in danger that they may in turn not be able to meet their payment obligations and this contributes to a domino effect.[19] Banks are however in a position to protect themselves against the effects of this type of risk if they have implemented adequate capital maintenance measures and maintain a sufficient buffer to survive the financial impact which a bank may suffer in these situations.

Another type of systemic risk is the risk that the public perception of a bank at a particular point in time may be that all other banks are in the same position as a bank which has failed and in reaction the public will move their deposits to banks which

[18] Saambou curatorship http://www.reservebank.co.za/internet/publication.nsf/APCV /ADACA838C01EB9E542256B61003497F1?opendocument (20-09-2010).
[19] Cranston *Principles of Banking Law* (2003) 67.

are in their perception the strongest. This is effected by depositors rushing to withdraw deposits, even if the banks perceived to be unhealthy are in actual fact perfectly healthy financially and a liquidity crisis may be faced by such banks which are perceived to be unhealthy in the event that there is a sudden rush by depositors to withdraw their deposits with the bank.[20]

Runs on banks pose a significant risk to the well-being of banks, and can within a short period of time place a bank into a crisis. An example of a run is Northern Rock in the United Kingdom. This run was put into effect by depositors.[21] The take over of Merill Lynch and the downfall of the Lehman Brothers were a result of a run which was caused within the banking market.[22]

Fraud and money laundering as well as terrorism are significant risks to banking systems and the costs associated with a bank being either the victim of fraud, money laundering or terrorism is significant. The costs related to these occurrences are not only quantifiable in monetary terms but are a social expense too in that when a bank is the victim of fraudulent or criminal activities the monetary system is misused to further the objectives of criminals. Fraud can be characterised either by fraud which originates from inside a specific banking institution or fraud which originates from outside a bank. Examples of internal fraud includes the gradual payment of money to non-existent nominees or borrowers, and fraud from outside includes cheque, mortgage and credit card fraud.[23]

Yield risk involves the risk that a bank may not be in position to produce sufficient income to cover payments for its liabilities. Market risk exists within the banking marketplace and could arise from fluctuations in price of certain financial instruments. Operational risk exists where a specific bank's internal controls and procedures fail, being either from a cause which originated within a bank or from outside a specific

[20] Cranston *Principles of Banking Law* (2003) 67.
[21] A run by small depositors is caused when a large amount of small depositors from the public within a short period of each other withdraw their deposits in the belief that that a bank may be declared insolvent; A run by the market is when banks who have inter-bank deposits rush to withdraw their deposits within a short period of time due to the belief that the bank may be declared insolvent.

[23] Cranston *Principles of Banking Law* (2003) 690-70.

bank. Management risk could exist in that managers or directors may not be entirely qualified for their positions and will not act in the best interest of a bank.[24]

Banking supervision and the prudent regulation of banks has become even more important with the failure and rescues of multinational banking institutions during the world economic crisis. This has alerted the world to the considerable risks which are involved in the banking industry including the risks which banks pose to each other in their dealings on an international level and the importance of ensuring that banks are managed properly to guard against their failure.

2.2.6 *Bank Rescues*

Various approaches have been identified in rescuing banks on an international level and these will be dealt with in the various jurisdictions which will be assessed in terms of banking supervision.

The impacts of bank rescues are felt on domestic capital levels and the existence of public doubt as to the economic controls which exist. The impact which bank failures have on the capital levels of a country are mainly in the form of the deposits lost by depositors. In itself the supervision of banks to avoid bank failures is more than sufficient motivation to rescue a bank.[25] The effects down the line are also to be considered especially in terms of the losses of deposits by companies which employ individuals. The importance of putting measures in place to avoid bank failures is especially important in countries where a culture of depositing funds with banks is widely observed and where all a depositor's savings will be held by a single bank, making the role of a bank as intermediary between borrowers and savers all the more important.

In some instances banks can be assisted out of a position of distress and the causes of a bank's distress can be resolved by way of the application of funds to a short term

[24] "Bank of England Basic Principles of Banking Supervision" http://www.bankofengland.co.uk /education/ccbs/handbooks/pdf/ccbshb07.pdf (15-09-2010).

[25] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 71.

liquidity crisis. The South African context this is where the South African Reserve Bank will for instance provide liquidity assistance as a "lender of last resort". There are however specific requirements which have to be in place for the South African Reserve Bank to do this, for example that a bank guarantee has to be provided by a distressed bank before financial assistance is given.[26]

A question which arises in the consideration of bank rescues is whether all distressed banks should be saved? A distinction can be drawn here between a bank which is experiencing a temporary liquidity problem and a bank which is already technically insolvent already.[27]

It has been seen even in the South African context that bank rescue operations will not be invoked simply because the public's deposits are at stake or for the public interest alone and Saambou Bank was rather placed under curatorship, than being rescued.

The alternative to bank rescues is to ensure by proper supervision that banks have measures, standards and procedures in place and subscribe to best practice in order to be capable of withstanding any impacts on its business as well as the consequences of risk. This must have certainly been one of the motivating factors for banking supervision. I submit that this course of action has contributed to the strong banking system which exists in South Africa, and the continued implementation of best practice and preventative measures will only contribute to the resilience and foundation of any banking industry.

2.2.7 *Deposit Insurance and the associated moral hazard*

Deposit insurance has been identified as being one of the measures which could be put into place before the failure of a bank in order to protect depositors.

[26] Saambou curatorship http://www.reservebank.co.za/internet/publication.nsf/APCV/ADACA838C01EB9E542256B61003497F1?opendocument (20-09-2010).

[27] Cranston *Principles of Banking Law* (2003) 94.

A deposit insurance scheme involves the collection of a premium from a depositor to protect against losses which may arise from the closure or failure of a bank. It has been expressed that deposit insurance can warp the "risk-reward" decision making process which is made by the management of banks and could affect market discipline which requires that banks must be well-managed. This type of insurance is invariably aimed at small depositors and will usually protect them up to a certain amount only. A deposit insurance scheme, if well-managed, can contribute to the confidence which the public may have in banks and significantly lower the effect of a bank failure on small depositors.[28] In my opinion deposit insurance schemes are in the best interest of depositors, especially in light of the fact that the general public may survive on a daily basis off the funds which may have been deposited with a banking institution and may have been lost due to a bank's failure. However, emphasis should remain on the proper and responsible management of banks and deposit insurance schemes should not be viewed as being a safety net and excuse for poor management.

Deposit insurance has been identified as being a factor which may discourage banking regulators from rescuing banks.[29] A great consideration in saving banks is the interests of the public who are depositors in banks, but an assessment must firstly be made as to whether the bank is capable of being rescued. A bank cannot just be rescued for the sake of protecting depositors and within a certain period of time after the rescue is implemented just fail because its rescue was not viable to begin with. This shows that various factors need to be taken into account when considering whether to intervene and save a bank.

What follows is a broad inquiry into the development from Basel I up to and until the proposed Basel III and the need which established their formulation.

[28] Saambou curatorship http://www.reservebank.co.za/internet/publication.nsf/APCV/ADACA838C01EB9E542256B61003497F1?opendocument (20-09-2010).
[29] Cranston *Principles of Banking Law* (2003) 94.

2.3 *Why Basel I?*

The first recommendations of the Basel Committee were a formulated set of principles, not publicly available at the time, which mainly advised that the duty of supervising international banking establishments in a specific country should be the mutual responsibility of the country in which the international bank finds itself and the country from which the bank originates. This document was referred to as the 1975 Concordat and was later replaced by the 1983 Concordat which incorporated the principle of consolidated supervision.[30]

The Basel Committee became increasingly concerned that the capital levels of major international banking institutions were declining while countries which were heavily indebted were experiencing growth and to this end moved towards a greater convergence in the manner in which adequate capital levels were measured. The failure of Bank of Commerce and Credit International contributed to this concern. The 1988 Basel Accord was approved by governors of the respective reserve banks, and provided for a minimum ratio between capital levels and risk-weighted capital assets.[31]

Criticism leveled at Basel I included that, although it introduced a straight forward risk weighting scheme which was transparent, it did not adequately account for the variances between various bank assets in that loans to big corporations would attract the same capital requirements as bonds which had a higher risk of default by borrowers. Another point of criticism is that mortgage bonds required the same level of capital regardless of the credit rating or credit score of a mortgagor. Treating all banks equally regardless of the risks which they took had the effect that banks which took higher risks were advantaged and could expect higher returns and at the same time not be required to hold extra capital due to their increased risk.[32]

[30] Cranston *Principles of Banking Law* (2003) 105.
[31] "The history of the Basel Committee and its Membership" August 2009 http://www.bis.org/bcbs/historypdf (20-9-2010).
[32] Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 358.

Basel I was never intended to be a document which would remain unchanged, but rather a document which would evolve and consequently various amendments have been made thereto.[33] This is what is seen in the formulation of Basel II.

Basel I paved the way for banks to comply with best practice and secure their existence. Basel I was most definitely a step in the right direction but required adaptation which would be suitable to large complex banks which is what Basel II was aimed at achieving.

2.4 *Why Basel II?*

The Basel Committee released a new capital Framework in June 2004, known as the International Convergence of Capital Measurement and Capital Standards: a Revised Framework which consisted of three pillars namely, minimum capital requirements, supervisory review of capital adequacy, internal assessment processes as well as required levels of disclosure which would improve discipline in the market and promote safe and responsible banking practices.[34]

Basel II represented a major revision of the international standard of Basel I.[35] Basel II application is to take place through consolidated supervision which means that any holding company of a bank, regarded as the "parent entity", is responsible for the monitoring of risk for an entire banking group.[36]

One difference between Basel I and Basel II is that Basel II offers a more holistic view of minimum standards. Basel II is a broader perspective and introduces three "pillars" which are aimed at being mutually enforcing. The first pillar deals with minimum risk-based capital requirements, the second pillar deals with guidelines for supervising the internal risk management of banks which also recommends that banking regulators recommend that banks hold capital levels higher than

[33] "The history of the Basel Committee and its Membership" August 2009 http://www.bis.org/bcbs/historypdf (20-9-2010).

[34] "The history of the Basel Committee and its Membership" August 2009 http://www.bis.org/bcbs/historypdf (20-9-2010).

[35] "Consensus achieved on Basel II proposals" www.bis.org/press/p040511.htm (21-09-2010).

[36] Meiring "Defining basel II part II" 2008 *Without Prejudice* 12 12.

recommended in the first pillar to act as a buffer, and the third pillar deals with new public disclosure requirements which aim to increase transparency and promote increasing effective market discipline of adequate capital held by banks.[37]

Resilience to financial shocks has become topical with the recent world economic crisis and assisting banks to withstand such shocks is the current focus of the Basel Committee in formulating Basel III. It is worth noting that although Basel II has been implemented in South Africa, this is not the case in all countries. For many countries Basel II will in all likelihood not be applied in time and the implementation of Basel III will take place instead once finalised.

2.5 *Basel III in the future*

The Basel Committee has embarked on a process whereby it seeks to improve on the framework set by Basel II, specifically by enhancing regulation, supervision and the management of risk within the banking sector. Basel III is seen as being a complete reform of the measures already implemented and aims to improve the resilience of banks during financial and economic stress.[38]

A broad framework for Basel III was agreed on by the central bank governors and heads of supervision, which is the Basel Committee's oversight body, in September 2009 and concrete proposals were set out in December 2009. Basel III is seen as part of the Basel Committee's continuous effort to improve the regulatory framework within the banking industry and builds on the standards set out in Basel II.[39]

The proposed changes to Basel II aim to address identified shortcomings and to promote a banking sector which can enhance sustainable growth in the long term. In light of the recent shocks to the world economy the quality of a bank's capital has become even more important to ensure that banks are able to withstand events which threaten economic stability on an international level. This is referred to as being "loss

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[37] Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 360.

[38] "International regulatory framework for banks (Basel III)" http://www.bis.org/bcbs/basel3.htm (19-9-2010).

[39] International regulatory framework for banks(Basel III)" http://www.bis.org/bcbs/basel3.htm (19-9-2010).

absorbing capital". Further changes to Basel II include that all risks must be accounted for and the building of buffers in good economic circumstances to draw on during periods of economic stress is also recommended.[40]

Taking into account the fact the Basel III is geared to make the banking industry even stronger to the shocks which it had suffered during the world economic crisis, it is clear that this was an underlying factor in deciding that Basel II had to be improved.

The final version of Basel III is yet to be released, and thus commentary on its contents with certainty is not entirely possible at this stage, however, any attempt to improve the capacity of banks to withstand economic shocks will contribute greatly to the stability of the international banking industry.

[40] "Fundamentally Strengthening Regulatory Framework for Banks" http:// www.bis.org/ review/r 100903a .pdf (17-09-2010).

CHAPTER 3

BANKING SUPERVISION AND THE IMPACT OF BASEL II ON VARIOUS JURISDICTIONS

3.1 *Introduction*

The then chairman of the Basel Committee Jaime Caruana said in a press release that, "Basel II introduces a far more comprehensive framework for regulatory capital and risk management than we have ever known".[41]

Banking supervision is dealt with differently around the world as well as in the jurisdictions under discussion. As will be seen the structure of banking supervision in the United Kingdom involves a system where three supervising institutions are involved. In South Africa the duty of supervising banks falls on a single institution, the Banking Supervision Department of the South African Reserve Bank, and in the United States of America is the duty of the Federal Reserve and certain government agencies.

All three jurisdictions under discussion are members of the Basel Committee and thus have agreed to implement the principles and standards of Basel II.[42]

Various jurisdictions can hardly be expected to approach and implement banking supervision principles in the same way, due to varying economic circumstances and approaches to banking as well as varying banking systems.

In this chapter the basic nature of banking supervision within the United States of America, South Africa and the United Kingdom, as well as the impact of the current banking supervision framework (Basel II) on each jurisdiction will be assessed.

[41] "Consensus achieved on Basel II proposals" www.bis.org/press/p040511.htm (21-09-2010).

[42] "The History of the Basel Committee and its Membership" http://www.bis.org/bcbs/history.htm (30-09-2010).

It must be kept in mind that the framework of Basel I is much less complicated than Basel II and thus the implementation of Basel II would have a much greater impact and be more difficult to implement.[43] The impact which Basel II had on banks is far greater than Basel I for the reason that it affects the entry and operations of foreign banks into other countries and thereby also affects the negotiations which are coupled therewith.[44]

The International Monetary Fund identified that a focus on speedy compliance with Basel II rather than ensuring a high quality compliance framework could pose a risk to implementation of Basel II but however indicated that the implementation of Basel II provides a unique opportunity through the diagnosis of current systems for even more improvement of the systems which were in place and would introduce the sharing of information between supervisors of different countries.[45]

The procyclical impacts of Basel II have been considered on a wide level in that for as long as the rating systems of banks are designed to change with the risk of borrowers defaulting, the capital requirements of banks will rise in economies where there is a recession and decrease in economies where growth is experienced. The maintenance of macroeconomic stability was identified as an area which may pose a challenge in the implementation of Basel II.[46]

The introduction of guidelines which effectively involve that capital requirements are more closely related to risks as measured by credit ratings have the effect that banks have to apply a standardised approach where capital requirements are based on agency ratings and more advanced banks are allowed to make use of internal ratings

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[43] Cornford 'The Global Implementation of Basel II Prospects and Problems" http://www.g24.org/cornfor2.pdf (18-09-2010).
[44] Cornford 'The Global Implementation of Basel II Prospects and Problems" http://www.g24.org/cornfor2.pdf (18-09-2010).
[45] "IMF Executive Board Discuss the Implications of the new Basel Accord" http://www.imf.org/external/np/sec/pn/2005/pn05154.htm (15-09-2010).
[46] Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 373.

based approaches which involve that the requirements are based on the outputs of banks' own ratings systems.[47]

When assessing the impact of Basel II on the mentioned jurisdictions, it should be borne in mind that many of the identified impacts could be common to all banks in all the identified jurisdictions, as all banks and supervisors of banks would have had to put systems and processes in place on how to comply with the requirements of the new framework individually. The procedures and implementation plans of various large banks in the various jurisdictions were assessed only in light of information which was available at the time of this study, and the mentioned banks may have implemented more procedures and measures during implementation of Basel II than that mentioned in documentation which is publicly available.

Basel II has been the focus of many authors in terms of the implementation of Basel II and the obstacles which need to be overcome in doing so. Challenges in implementation have been identified for bank regulators as the implementation of the verification of systems which validate the ratings of banks as well as the monetary investment required for putting in place the required information systems infrastructure in order to be in a position to internally manage risks.[48]

3.2 *Banking supervision in the United States of America*

The central bank of the United States of America is known as the Federal Reserve System (Hereafter referred to as the Federal Reserve) and was founded by the United States Congress in 1913 in order to provide the country and its people with a safe, flexible and stable financial system.[49] The establishment of the Federal Reserve was greatly attributed to various banking panics and financial instability in the economy in the early twentieth century.[50]

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47 Benford and Nier "Monitoring cyclicality of Basel II Capital Requirements" http://www. bankofengland .co.uk/publications/fsr/fs_paper03.pdf (30-09-2010).

48 Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 373.

49 "The federal reserve system, functions and purposes" http://www.federalreserve.gov/pf/pf.htm (30-09-2010).

50 Barnanke "The Federal Reserve's Role in Bank Supervision" http://www.bis.org/review/r100318a.pdf (30-09-2010).

Prior to Basel I the responsibility of devising and implementing capital adequacy standards was that of the United States of America Congress. The duty was later transferred to the governors of the Federal Reserve through enactment of the International Lending and Supervision Act, which made it possible for the Federal Reserve to deliberate and negotiate on minimum international capital adequacy guidelines with other central banks and motivated the adoption of a uniform set of rules in this regard.[51]

The Federal Reserve has a key role within the economy of the United States of America in relation to preventing and mitigating financial crisis, as a result of its powers in terms of being in a position to provide liquidity to the financial system, its role in the payment system of the country, its international relations with central banks of other countries and its responsibilities for macroeconomic stability.[52]

The Federal Reserve System's duties include conducting the country's monetary policy, the supervision and regulation of banks to ensure the safety and soundness of country's banking system, to protect consumers, maintain a stable financial system, control systemic risk and provide financial services to various stake holders.[53] These duties are laid down in the Federal Reserve Act.[54]

The Federal Reserve System has joint responsibility for banking supervision and regulation with a number of federal and state government agencies. These federal and state government agencies include the Securities Exchange Commission and the Commodity Futures Trading Commission. State banks as well as foreign banks are supervised and in some instances also the foreign operations of banks of the United States of America.[55]

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[51] 1983;see s 908(3)(c) ; 1993
[52] Barnanke "The Federal Reserve's Role in Bank Supervision" http://www.bi s.org/review /r100318a.pdf (30-09-2010).
[53] "The federal reserve system, functions and purposes" http://www.federalreserve.gov/pf/pf.htm (30-09-2010).
[54] 1913; see s 11
[55] Barnanke "The Federal Reserve's Role in Bank Supervision" http://www.bis.org/review/r100318a.pdf (30-09-2010).

The existence of various bank regulators has been identified as being a weakness of banking supervision in the United States of America.[56]

The approach to bank rescues in the United States of America is said to be legalistic in nature due to the fact that the banking community is not involved to a great extent and the fact that the responsibility of rescuing banks is that of federal agencies, specifically the Federal Deposit Insurance Corporation and not that of the central bank, the Federal Reserve System.[57]

There are perhaps too many institutions, with various mandates, involved in banking supervision in the United States of America which complicates matters. It has been seen in South Africa that a single independent bank regulator can be successful. The possibility exists that there could be a duplication of tasks if multiple parties are involved in the supervision of banks.

3.3 *Impact of Basel II on the United states of America*

The United States of America, specifically the Federal Reserve, shortly after agreement was reached on the methods of Basel II, issued regulations and rules through rule making initiatives similar to the provisions of Basel I applicable to its domestic banking system. There was not much refusal to accept the implementation of these regulations.[58]

In the United States of America the New York Federal Reserve Board informed the twenty largest banks in the country by when to have implemented the internal risk based advanced approach. Smaller banks could decide whether they would implement Basel II. The date by which banks had to be in compliance with Basel II was delayed

[56] Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law* 10.
[57] Cranston *Principles of Banking Law* (2003) 96-97.
[58] Tarbert "Rethinking Capital Adequacy: the Basle Accord and the New Framework" 2001 *Bus. Law* 767 789.

to January 2008 and only the largest banks in the country are rquired to comply with the provisions of Basel II.[59]

The USA also followed a system whereby comments were received from all role players and considered for implementation.[60]

The Bank of America in its 2008 annual report indicated that it aimed at full compliance with Basel II by the end of 2011. This is later than most.

3.4 *Banking supervision in South Africa*

The regulation and Supervision of banks in South Africa has been the responsibility of the South African Reserve Bank, which is the central bank of South Africa, since 1920 through the enactment of the Currency and Banking Act,[61] and was the duty of the Department of Finance of the South African Government before then. [62]

The main objective of the South African Reserve Bank is ensuring the stability of domestic price levels and the protection of the South African currency with an interest in the economic development and growth of South Africa on a level which ensures sustainability.[63]

The South African Reserve Bank was established in order to remedy the poor financial and monetary conditions in South Africa after the First World War which

[59] "Data Management Challenges for Basel II Readiness" http://www.it-observer.com/data management-challenges-basel-ii-readiness.html (27-09-2010) ; The Bank of America made it the responsibility of its audit and finance committee to oversee plans to implement Basel II within the bank and implemented measures to ensure holding of adequate capital levels for compliance with Basel II. The bank implemented Basel II by what is called a parallel run. This is a process whereby the requirements of Basel I and Basel II are implemented and observed concurrently until such a time as Basel II is effective. The bank implemented a parallel test period which was applicable to credit and operational risk rules which involved approval in terms of supervisory elements and there after implemented.

[60] Krozner "Basel II Implementation in the United States http://www.bis.org/review/r070716e.pdf (30-09-2010).

[61] Act 31 of 1920.

[62] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 81.

[63] Act 31 of 1920.

led to the illegal outflow of gold from South Africa causing domestic banks to experience liquidity problems.[64]

The Constitution of the Republic of South Africa provides for the role of the South African Reserve Bank, setting out its functions and object as the central bank of South Africa. The Constitution affirms the independence of the South African Reserve Bank and its interaction with government.[65]

Supervision of banks in South Africa takes place through the Registrar of Banks by the control of the banking supervision department of the South African Reserve Bank. The South African Reserve Bank is regulated by the South African Reserve Bank Act.[66]

The South African Reserve Bank maintains relationships with the Bank for International Settlements and participates in a number of its committees and forums, which includes the Basel Committee.[67]

The approach which is followed in South Africa is that the financial system is the place where savings of the community are kept safe and thus requires protection. The fact that the duty of supervision of banks lies with the central bank of a country seems to be a model which is acceptable internationally.[68]

In South Africa the existence of banks are regulated in terms of three enactments, namely the Co-Operative Banks Act,[69] the Banks Act,[70] and finally the Mutual Banks Act.[71] The distinguishing factors in terms of the various types of banks which are

[64] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 83.
[65] Act 108 of 1996; see sections 223, 224, 225.
[66] 90 of 1989.
[67] Mboweni "Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank" http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).
[68] De Jager "The South African Reserve Bank: An Evaluation of the Origin and Status of a Central Bank Part 1" 2006 *SA Merc LJ* 159 280.
[69] 40 of 2007 refer to secion.
[70] 94 of 1990 refer to section.
[71] 124 of 1993 refer to section.

governed by the various enactments lies in the definition of the each type of bank, which will explained briefly.

A co-operative bank is a bank whose members are of a similar profession and are employed by the same employer in the same business district or who have a common membership in an association or organisation or live in the same community in a specific geographic area.[72]

A mutual bank is a juristic person registered as a mutual bank, whose members are shareholders of the bank and may exercise control as a shareholder at a general meeting of the bank.[73]

In terms of the Banks Act,[74] a bank is regarded as such in terms of the Act in the event that it conducts the business of a bank and solicits deposits from the general public.[75]

The principles and recommendations made by the Basel Committee have been given legislative force in South Africa by the incorporation of its recommendations into the Banks Act.[76] The Banks Act requires that the Registrar of Banks must be satisfied that the banking authority in the country of origin of a bank wishing to establish business in South Africa accepts and is committed to compliance with the proposals, guidelines and recommendations made by the Basel Committee.[77]

The Banks Act,[78] imposes certain sanctions on banks in South Africa should they not comply with or be unable to comply with the requirements of prudential supervision set out therein. The act also places an obligation on a bank to lodge regular returns with the South African Reserve Bank which indicate that it complies with the requirements in relation to minimum liquid assets, minimum capital, reserve funds in

[72] See s 1 of Act 40 of 2007 refer to section.
[73] See s 1 of Act 124 of 1993 refer to section.
[74] 94 of 1990.
[75] See s 1 of the Bank Act 94 of 1990.
[76] 94 of 1990.
[77] s 18A Act 94 of 1990.
[78] s 73 Act 94 of 1990.

respect of a banking group as well as minimum share capital and unimpaired reserve fund requirements.

3.4.1 *Single Regulator*

A discussion paper was issued at the request of the Policy Board for Financial Services and Regulations in November 2000, known as the Falkena Report which dealt with financial regulation in South Africa. The Falkena report was to investigate whether a single regulatory agency for banks should be created, whether the South African Reserve Bank should have this responsibility in South Africa and whether the South African Reserve Bank should in addition to its duty to protect price stability also be responsible for promoting financial stability in South Africa.[79]

The Falkena report identified three objectives of regulation. These objectives were securing systemic stability in the economy, ensuring institutional safety and soundness and promoting consumer protection.[80]

Recommendations made in the Falkena Report included that the prudential regulation of banks and holding companies should be the responsibility of the South African Reserve Bank, while the supervision of all non-banking institutions should be the function of the Financial Services Board.[81]

Van Jaarsveld was of the opinion at the time that in comparison to South Africa, the fact that a single regulatory authority was in place in the United Kingdom then did not mean that the same was fit for South Africa and the South African Reserve Bank. Van Jaarsveld made four recommendations and stressed the importance of having qualified supervisors, intense training in the financial sector, a wider range of powers for bank supervisors when requesting disclosure, accountability of managers and directors as well as avoiding the rescue of banks. Finally it was recommended that South Africa

[79] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 88.
[80] Falkena "Financial Regulation in South Africa" http://www.reservebank.co.za/internet/publication.nsf/0/06011DB3E559952242256B52005B7757/?opendocument (18-09-2010).
[81] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 89.

should make use of its opportunity to learn from the international banking sector while being mindful of specific domestic requirements are in terms of banking supervision.[82]

Within the context of banking rescues in South Africa the demise of Saambou Bank Limited (hereafter referred to as Saambou Bank) was a situation where the route of curatorship was rather followed than the lender of last resort option offered by the South African Reserve Bank.[83] Saambou Bank was placed under curatorship on 9 February 2002. At the time it had 520 000 depositors. The Minister of Finance at the time indicated in a statement to parliament that the decision to place Saambou Bank under curatorship was made after considering the fact that the running of a bank is more than just managing a business in the ordinary course, and the fact that the funds of depositors are managed by banks which is a very important social function requiring trust and confidence in banks. He emphasised that the decision to place Saambou Bank under curatorship was made in the public interest to stop the abnormal outflow of funds and to protect depositors' funds due to a loss of confidence in the banking system. Curatorship was the mechanism identified as being the most cost-effective in the situation, and also the most certain and immediate solution.[84]

South Africa is a jurisdiction where the success of a single bank regulator is evident. The standards of banking supervision in South Africa are high and the South African Reserve Bank has responsibly and proactively discharged its duties as the central bank and supervisor of banks. This is also evident from the manner in which Basel II was implemented in South Africa.

[82] Van Jaarsveld "Domestic and International Banking Regulation and Supervision – Defying the Challenges" 2002 *SALJ* 100.

[83] Saambou curatorship http://www.reservebank.co.za/internet/publication.nsf/APCV/ADACA838C01EB9E542256B61003497F1?opendocument (20-09-2010).

[84] "Statement to Parliament by the Minister of Finance ,Trevor Manual, on the Placement of Saambou Bank Limited under Curatorship" http://www.info.gov.za/speeches/2002/020214411p1002.htm (15-09-2010).

3.5 *Impact of Basel II on South African banking law*

When the implementation of Basel II became necessary within the South African context the banking supervision department of the South African Reserve Bank distributed a number of consultation papers intended to express their view on a proposed approach to the implementation of Basel II in South African banks. This process was intended to gain the perspective of banks and recommendations on the impacts and experiences which banks may have had during the process of implementation. [85]

Basel II was implemented in South Africa through the Banks Amendment Act.[86] The Act sets out the following procedures for implementation of Basel II, being the clarification of the responsibilities and duties of banks, banking groups and members of the board of directors of the various banks, increasing the requirements for reporting and providing for comprehensive disclosure by banks and banking groups. Further amendments to the Banks Act also facilitated the calculation of minimum capital requirements for exposure to credit risk, market risk and operational risk.

Basel II was implemented in South Africa on 1 January 2008 and its principles remain the objectives and guiding principles of the regulatory and supervisory framework of the South African Reserve Bank. The South African Reserve Bank continued to refine its Basel II revised regulatory and supervisory approach during 2008 and 2009 by focusing on internal capital adequacy assessment processes implemented by banks, reviews of credit, market and operational risk and the processing of applications by banks to make use of advanced approaches to calculate their minimum credit requirements in terms of credit and operational risk.[87]

[85] "First Consultative paper on the implementation of the new Basel Capital Accord No. 2/2004" http://www.reservebank.co.za/internet/publication.nsf/WTV/Banksactcirculars8463D78301D82DAD42257450002617BA?OpenDocument (14-09-2010).

[86] 20 of 2007.

[87] Mboweni "Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank" http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).

The South African Reserve Bank held discussions within the banking industry on stress-testing frameworks which it rolled out and continued to internally improve its own knowledge base to effectively monitor the stress testing framework of banks.[88]

The South African Reserve Bank assessed the readiness of South African banks for the implementation of Basel II in all banks, branches of foreign banks and mutual banks by issuing a questionnaire and arranged interfaces between banks to discuss issues which required clarification.

In response to the implementation of Basel II by South African banks, the South African Reserve Bank indicated its support as affirmed under Basel I. The mission the Department for Banking Supervision to promote the soundness of banks through the effective application of international regulatory and supervisory standards was also affirmed thereby. The South African Reserve Bank appreciated that various changes had come about in the banking sector which involved the advancement of technology and that complying with the principles as set out in Basel II would be advisable and desirable for South African banks.[89]

More specifically the enactment of the provisions of the new capital framework, no doubt required that the legislative and regulatory framework in South African had to be amended accordingly. The amendments in accordance with the framework take place on a level of legislation, the Banks Act,[90] and the regulations thereto, as well as on the level of practice notes, directives and bank circulars which were issued in an attempt to provide guidance and procedures on matters relating to the banking industry. The Banks Act may only be amended by Parliament according to procedures prescribed, the regulations to the Banks Act may be formulated, amended and issued by the Minister of Finance. Practice notes, directives and circulars may be issued by the Registrar of Banks.

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[88] Mboweni "Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank" http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).

[89] "Basel II: International convergence of capital measurement and capital standards - a revised framework Banks Act circular 14/2003"http://www.reservebank.co.za/internet/publication.nsf/WTV/Banksactcirculars8463D78301D82DAD42257450002617BA?OpenDocument (14-09-2010).

[90] 94 of 1990.

The banking supervision department of the South African Reserve Bank requested that all banks in South Africa perform assessments of their readiness for Basel II and compare their current internal regulatory systems with what was expected under the new framework in order to plan for the implementation. Banks were also asked to identify responsible persons for the management of the implementation process as well as the setting of deadline dates. A process of parallel runs was implemented as a transitional measure to facilitate the lodgment of returns under both Basel I and Basel II. The South African Reserve Bank made the necessary adjustments to its internal systems, specifically its information system database, and looked at approving bank approaches to credit and operational risks. It also developed its staff compliment to deal with the new challenges which Basel II brought about. The approach which was followed by the South African Reserve Bank for implementation of Basel II was a process of consultation and interaction between the various parties in the banking industry, namely the banks of South Africa, National Treasury, external auditors, the Banking Association of South Africa and the South African Reserve Bank.[91]

It is evident that most banks in South Africa, especially the large banks, took the implementation of Basel II very seriously and the project plans involved spread over years and involved countless hours and hundreds of employees. What is encouraging about the South African implementation of Basel II is that it is ahead of many international banks, on which bigger economies rely, as far as the progress of implementation is concerned. Some countries will not even reach full compliance with Basel II in 2010. The responsible role of the South African Reserve Bank in the

[91]Standard Bank adopted an approach to the implementation of Basel II which involved the standardisation of all process in aligning itself with Basel II, with the aim to standardise procedures in all the countries where it operated at the time. The bank also put into place an operational risk database and added to it risk and control assessments. It prepared its systems for the future use of advanced measurement approaches. Standard Bank also enhanced their systems to manage defaults on loans as well as their collateral management processes which would allow the management of risks on the bank's credit portfolio to meet the requirements of Basel II. Standard Bank aimed to develop and implement a group wide risk and capital measurement system as well as a reporting system which would support the reporting processes of the bank and include the reporting requirements under Basel II. Measures put in place involved systems which would identify its respective clients according to industry by way of using portfolio segmentation techniques in order to comply with Basel II. The bank reported in its 2007 interim financial results that it had experienced an increase in operating costs and ascribed a part thereof to the increased regulatory duties and work required to implement Basel II.

timely implementation of Basel II must be recognised and has most definitely contributed to the strong banking system which exists in South Africa currently.

3.6 *Banking supervision in the UK*

Financial stability in the United Kingdom is a shared responsibility between the Bank of England, HM Treasury and the Financial Services Authority.

The two core purposes of the bank of England are to ensure monetary and financial stability. Responsibilities of the Bank of England in respect of monetary stability are set out in the Bank of England Act,[92] and its current responsibility for financial stability in the Banking Act.[93]

In 1997 the Financial Services Authority was established with the power to supervise all financial activities in the United Kingdom through the Financial Services and Markets Act.[94] During this time the Bank of England, the FSA and the HM Treasury formulated a Memorandum of Understanding in order to reach an understanding as to what each institution's duties are. It was agreed that the obligations of the Bank of England are supervision of the monetary infrastructure of the financial system as well as the payment system. The Financial Services Authority is responsible for matters which pertain to regulation and HM Treasury is to maintain the legislative framework in terms of regulating banks as well as the general framework of this system. It also acts as a government department which entails the responsibility of fiscal, financial and monetary affairs in the United Kingdom.[95]

Hudson is of the opinion that where more than one party is made responsible for the same task confusion is likely to manifest with regard to which party is responsible for what eventually leading to conflict and ineffectiveness. He makes this observation specifically in relation to what he calls the "tri-partite banking regulation system" which exists in the United Kingdom and adds that this unsuccessful system of three

[92] 1998.
[93] 2009; "Bank of England Financial Stability Report June 2010" www.bankofengland.co.uk /publications /fsr/2010/fsr27.htm (19-09-2010).
[94] 2000.
[95] Hudson *The Law of Finance* (2009) 750.

functionaries was evident from the global financial crisis in the nationalisation of Northern Rock in 2007 and the failure of Bradford and Bingley in 2008, which required a takeover prompted by government motivation.[96]

Uniform standards in banking have also received recognition in the European Community, of which the United Kingdom is a member. For example in that a bank of a certain member state may establish branches and provide banking services to other members states without requiring authorisation. This shows that all member states recognise the licensing processes of other member states together with their minimum standards. Even if the licensing processes of certain member state banks are not recognised there is at least assurance that minimum standards are complied with.[97]

The directives of the European Community have been incorporated into the banking law in the United Kingdom and together with the rules incorporated in the United Kingdom, make up banking regulation.[98]

Bank rescues in the United Kingdom occurred a number of times and a culture has developed where banks are now stepping away from rescuing fellow banks, the responsibility falling here on the Bank of England. No power of rescue exists in the Bank of England Acts,[99] although the charters of banks give the Bank of England the power to contract which should include the power to step in and rescue banks. The Bank of England's responsibility to rescue banks is supported by the Memorandum of Understanding which exists between it and the Financial Services Authority where a real threat of systemic risk is present.[100]

The financial regulatory system of the United Kingdom will be reformed in the future and will move the regulatory framework which is currently in place to a system whereby prudential regulation of banks will be separated from oversight of consumer protection and market conduct, giving the Bank of England renewed duties with

[96]Hudson *The Law of Finance* (2009) 750-751.
[97]Cranston *Principles of Banking Law* (2003) 100.
[98]Hudson *The law of finance* (2009) 739.
[99]1946;1988.
[100]Cranston *Principles of Banking Law* (2003) 96.

regard to macroprudential regulation of the financial system in the United Kingdom. The process is aimed to be completed in 2012.[101]

I agree with Hudson that the having three institutions involved in the supervision of banks in the United Kingdom could pose problematic, but this remains to be seen once the new structure of supervision is fully implemented and functioning.

3.7 *Impact of Basel II on UK banking law*

The Bank of England enacted standards in domestic legislation by amendments to the Bank of England Act similar to those of Basel I and member countries of the European Union, which includes the United Kingdom, caused that capital adequacy directives were issued by the Council of Ministers of the European Union, which dealt with solvency ratios and own funds.[102]

Basel II implementation in the European Union will take place through the implementation of the Capital Requirements Directive which will act as a supervisory framework in the European Union similar to the capital measurement and capital standards reflected in Basel II.[103]

In the United Kingdom the procyclicality of Basel II was seen as the process whereby the use of ratings to set capital requirements and improving on risk sensitivity requirements introduces risk that capital requirements and standards may fluctutate to a great extent with economic conditions. In reaction to this risk the Financial Services Authority and Bank of England formulated and implemented a system to monitor the trends in Basel II requirements before its implementation, in order to see a shift in requirements which could have the effect that banks are not sufficiently capitalised during periods where there is great growth economically or the capability of banks to

[101] "Bank of England Financial Stability Report June 2010" www.bankofengland.co.uk /publications /fsr/2010/fsr27.htm (19-09-2010).

[102] Tarbert "Rethinking Capital Adequacy: the Basle Accord and the New Framework" 2001 *Bus. Law* 788.

[103] Capital requirements directive issued by the European Union will incorporate the terms of Basel II into European Community law. ; "Data Management Challenges for Basel II Readiness" http://www.it-observer.com/data-management-challenges-basel-ii-readiness.html (27-09-2010); Directive 2006/48/EC and Directive 2006/49/EC.

provide financial services during times of slow economic growth is affected negatively. The Bank of England identified that careful capital planning was required on implementing these principles.[104] [105]

3.8 *Conclusion*

It is clear that Basel II had a great impact on various banking areas. Without any doubt the cost implications of aligning an entire banking group with the requirements of Basel II were significant. The development and adapting of information technology systems to comply with the measures which Basel II required were significant in light of the fact that these systems required adaptation on a global level and for various economic conditions where international banks operated.

On a level of human capital, time and resources had to be invested in first becoming familiar with the requirements of Basel II and then implementing the required measures within in business units. Emphasis had to be placed on training of not only employees but the role players involved in managing the banks, namely the board of directors and executive management.

Banks implemented and created various committees which had the responsibility of guiding the massive task of implementing Basel II throughout banking groups. Even committees of the board of directors within banks assumed responsibility and were kept informed of the developments with regard to implementation of Basel II.

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[104] Benford and Nier "Monitoring cyclicality of Basel II Capital Requirements" http://www. bankofengland .co.uk/publications/fsr/fs_paper03.pdf (30-09-2010).

[105] Barclays indicated in its 2007 annual report that it had made changes to its impairment methodologies to bring them in line with the requirements under Basel II. The bank was also granted permission, by the Financial Services Authority, to make use of advanced approaches to credit and operational risk management. As part of its application to the Financial Services Authority to apply the Advanced Internal Ratings Based Approach Barclays assessed over two hundred models in order to ensure that the models were compliant with the requirements set by Basel II. Barclays also conducted various stress tests throughout the group as part of a wider risk management process and to learn more about the risk profile and effects which could manifest if certain external factors changed. HSBC identified that the implementation of Basel II across its entire group would pose a great challenge technologically and logistically taking into account that it has operations in different regulatory environments and would involve an extensive program of implementation.

A cost impact would no doubt also have been felt in the expenditure on consultancy fees, as banks are largely prone to appointing consultants to assist in various areas where the human resources of a bank do not possess the knowledge or skill base to implement and manage certain areas of business. Although there may have been significant costs for the banks, consulting companies would no doubt have seen an increase in revenue.

Various information technology systems throughout the diverse global operation of banks required development in order to accommodate stress testing and so also where parallel runs were implemented by banks.

Although the implementation of Basel II impacted on various business areas, it would however contribute to the safety of financial and monetary systems, to a greater extent than Basel I. Compliance with Basel II is an ongoing process which requires constant development, improvement and adaptation by banks.

Through the investigation of the impact of Basel II, it becomes clear that the impacts are not only seen in the use of new systems in banks under Basel II, but even more so in the preparation required for Basel II. The impacts of Basel II are definitely not felt on a purely economic level.

Compliance with Basel II will provide banks with far more than just compliance with the framework of Basel II but will have other benefits which will lead to improvement on various levels.[106] The great efforts to implement Basel II, no matter how cumbersome, still contribute to the stability of banks and pose advantages to banks on many levels except pure compliance with what is required by this accord.

[106]"Data Management Challenges for Basel II Readiness" http://www.it-observer.com/data-management-challenges-basel-ii-readiness.html (27-09-2010).

CHAPTER 4
LEGAL NATURE OF BASEL II

4.1 *Introduction*

What is of great interest about the principles and recommendations made by the Basel Committee is the fact that so many countries implement and apply them, without the Basel Committee having any real law making authority. This could be as a result of the realisation that it is in the best interest of the global banking industry to implement prudent supervision rules. The wide implementation and recognition of Basel II could also be an indication that various bank supervisors from countries throughout the world take to heart their duties as the guardians of the financial systems increasingly seriously. One can only refer to the significant recent economic crisis for motivation as to why banking supervision is so important and why even more should be done in this field to combat financial shocks ruining banks and placing economies into recession. It remains to be seen what the true legal nature of Basel II is and whether it would be possible to classify the accord as a contract, treaty, trade usage or new *lex mercatoria* or whether Basel II could even resemble the characteristics of any one of these possible classifications. Finally the nature of Basel II will be considered in comparison to the Uniform Customs and Practice for Documentary Credits 600 (hereafter referred to as the UCP).

The level at which Basel II was formulated and released for implementation, as well as the incorporation of the recommendations and principals in various jurisdictions to enforce compliance, deserves consideration.

The Basel Committee lacks authority to enact law and the G-10 countries which ascribe to the principles and recommendations laid down by the committee will almost always incorporate the principles and recommendations into their domestic legal frameworks. This process is identified as being made up of four steps, namely the Basel Committee will firstly deliberate and draft proposals and recommendations for regulation, after which consultative papers will be issued which address the proposed changes and recommendations and comments will be received from role players. These role players include banks, academics and governments as well as other interested parties. Once the process of receiving comments on consultative papers is complete the comments are assessed and the necessary changes are effected. The fourth step is where the member states of the Basel Committee agree to effect implementation of the changes or accords in their respective jurisdictions.[107]

What separates the Basel Committee from law making bodies is the final and fourth step outlined above, and according to Tarbert despite the fact that the Basel Committee does not possess the ability or power to make law, it is in actual fact a "generator" of international standards on capital adequacy. The enactment of the recommendations made by the Basel Committee are simply formalities due to their wide application.[108]

To a large extent the implementation and drill-down effect of the principles of banking supervision in the current framework depend on the cooperation of domestic structures as far as the implementation of and adherence to these principles is concerned. Whether countries choose to make compliance compulsory by legislating principles of Basel II, the enforcement of these principles is dependant on the extent to which the principles laid down by the Basel Committee are recognised by the banking supervisors or supervisory structures of a specific country. In my opinion the size and complexity of a country's banking industry and whether domestic banks to business internationally will be considerations in the decision whether to implement Basel II. Implementation will be a priority to countries with an interest in the stability of its monetary and banking systems, this should actually include all countries.

Freeland is if the opinion that since the endorsement by the G-10 Governors of the Basel Accords they have established a certain amount of persuasion behind the accords.[109]

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[107] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1788.
[108] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1788.
[109] Effros *Current Issues Affecting Central Banks* (1994) 232.

With Basel II recommendations not having any binding force, they are considered as being as being "soft law", which refers to legal "terms" or "informal duties" adopted under terms of formal or informal treaties or multilateral agreements.[110]

Soft law is regarded as undetermined standards which are agreed to and adopted by diplomatic conferences of international organisations or resolutions made by international organisations and intended to serve as instruction for the manner in which to behave in terms of agreed issues.[111]

The most successful regulatory proposals on banking supervision are said to be that created by the European Union which has incorporated principles and recommendations of the Basel Committee into its law by issuing banking directives to member states. This process has contributed to certain Basel II provisions having legal force and effect within the members states of the European Union and are in turn implemented either by the enactment of domestic legislation or are automatically of force in member states.[112]

Some writers have referred to the enactments of the Basel Committee as being "club" law in light of the fact that they are carved out by a club of powerful nations, being the G-10 countries and more specifically that the process could be seen as, "the "inculcation" of formal legal systems by central bankers "club' law".[113]

The documents issued by the Basel Committee are referred to as being "accords" and "concordats" due to their non-binding nature. Tarbert is of the opinion that this "divests" them from any binding legal authority but does show their political

[110] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1789.
[111] Dugard *International Law a South African Perspective* (2003) 36.
[112] Hudson *The Law of Finance* (2009) 739.
[113] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1799.

significance.[114] He is also of the opinion that the emergence of soft law is as a result of the shortcomings of "hard" law, which has binding legal authority.[115]

Tarbert sees the soft law nature of the Basel Accords as being positive in that its nature sidesteps two real difficulties which include the possible lack of cooperation between nations and the difficult process to be followed in the enactment of international legislation. By not having to overcome the mentioned difficulties, in his opinion, banking regulators from various and very different banking backgrounds are in a position to work together under a single set of standards for banking issued by the Basel Committee.[116] Tarbert identifies in the nature of the Basel recommendations that there is no risk of intrusion of national sovereignty and suggests that the Basel Committee could be a point of reference for models adopted for even further convergence on a level of other economic laws.[117]

The recommendations made and principles set out by the Basel Committee are applied in more than one hundred countries and has over time been seen as international standards of best practice.[118]

What follows will be an assessment of various types of possibilities of classification of Basel II either as an agreement, trade usage, a new *lex mercatoria* or a treaty. And finally the legal nature of Basel II will be compared to that of the UCP.

4.2 *Agreement*

In order to assess whether Basel II can be classified as an agreement it is necessary to consider the requirements for agreements in accordance with contract law. The law of contract as it stands in South Africa will be used as the point of departure.

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[114] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999- 2000 *U. Pa. L. Rev* 1771 1789.

[115] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1789.

[116] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1790.

[117] Tarbert "Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond" 1999-2000 *U. Pa. L. Rev* 1790.

[118] Cornford 'The Global Implementation of Basel II Prospects and Problems" http://www.g24.org/cornfor2.pdf (18-09-2010).

The Constitution of the Republic of South Africa lays down the authority for the negotiating and signing of international agreements as well as its binding nature. Any international agreement is regarded as law in South Africa when enacted into law by the South African parliament. South Africa is bound by international agreements concluded before the enactment of the Constitution of the Republic of South Africa.[119]

At the outset it is necessary to appreciate the fact that contracts exist in various forms and in certain situations they are required to comply with certain formalities for validity. In order to establish whether Basel II is an agreement or contract it is necessary to investigate what the requirements are for the conclusion of a valid contract and compare these requirements with the nature of Basel II.

An offer is a proposition which is made in terms of a party to a contract indicating that he wishes to enter into an agreement on specified terms.[120]

A contract is normally created when an offer is made by one person and accepted by another.[121] Thus a contract is characterised by the extension of an offer by one party and the acceptance by the party to who the offer was extended.

The requirements for a valid agreement include that there must be consensus between the parties, the parties to the contract must have capacity to contract, performance in terms of the agreement must be possible, the conclusion of the agreement and the performance and object of the agreement must be lawful, the formalities for the agreement if any must be complied with and there must be clarity on the obligations created by the agreement.[122]

[119] See s231 of Act 108 of 1996.
[120] Kerr *The Principles of the Law of Contract* 1998 65.
[121] Kerr *The Principles of the Law of Contract* 1998 61.
[122] Van Aswegen, Hawthorne, Floyd, Pretorious and Erasmus *Law of Contract* (1996) 6-7.

Consensus is made up of three elements namely agreement as to the outcome of the agreement, agreement as to the fact that the parties wish to bind themselves to the agreement in the legal sense and that both parties are aware that agreement has been reached between them.[123] If this requirement is considered in light of the Basel II, it is clear that there is agreement as to the outcome of the agreement, there is also agreement as to the fact that the members of the Basel Committee will comply with the standards and principles formulated by the Basel Committee and the members of the Basel Committee are aware that other members are in agreement.

Capacity to contract includes whether an individual has the capacity to enter into a valid contract and can be influenced by any number of factors, which include age and mental capacity. For the purpose of considering whether the members of the Basel Committee on Banking Supervision have capacity to enter into agreement with each other, it will be presumed that they do have the necessary capacity and authority delegated to them by their respective governments.

The validity requirement that the parties must be capable of performing in terms of the agreement, will be dealt with on the basis that the incorporation and application of Basel II will be possible in domestic legal systems. The application and implementation of Basel II within the various countries could be considered performance in terms of the agreement between members of the Basel Committee.

The requirement of lawfulness, to conclude a valid agreement will be dealt with in light of the fact that the principles laid down in Basel II are lawful as they contribute to best practice within the banking industry and most definitely cannot be regarded as having unlawful consequences.

Basel II will not be considered in light of or in comparison to whether it forms a specific contract, but rather whether it forms an agreement in the general sense, and the specific nature of a contract which may exist will not be considered in the current discussion.

[123] Van Aswegen, Hawthorne, Floyd, Pretorious and Erasmus *Law of Contract* (1996) 13.

The fact that there must be clarity as regards the obligations which the agreement will create implies that each party must know what will transpire from the agreement.

The members of the Basel Committee do at the moment when they agree to the principles and the recommendations made by the Basel Committee and in driving application of the principles of Basel II acknowledge that they are aware of the consequences which should transpire from the agreement reached as members of the Basel Committee. This furthers a conclusion that Basel II could be regarded as a type of international agreement.

As can be seen with the conclusion of many contracts, certain rights and duties are created but also certain remedies in the event of breach. The factor which steers me away from a conclusion that Basel II is binding contract is that non-compliance with the principles set out in Basel II cannot be remedied and that a member of the Basel Committee will not have any rights as such to either enforce compliance with Basel II or have a legal remedy available in these circumstances. Although I do recognise that Basel II is to a great extent a form of agreement, the fact that it is not enforceable either by penalty to a non-complying member or does not provide a remedy to an innocent party will not sustain a classification of Basel II as an agreement in the contractual law sense.

4.3 *Treaty*

Within in the realm of international law many customs are observed and agreements complied with but most countries desire to have a system which set out rules, or a framework of rules to be abided by in order for certainty and good order.[124]

International law today is a significant departure from what it was in the middle of the last century due in part to the significant advances made in technology and the fact that a global community has been created. This is visible in trade relations and

124 Shaw *International Law* (2008) 7.

interaction between nations from separate corners of the earth. Business has to a large extent also made the world a great deal smaller, thus effecting globalisation.

A treaty is an agreement, in writing, which is concluded between states which functions within the realm of international law. A treaty can also be concluded between a state and an international organisation.[125]

No substantive requirements exist for the conclusion of treaties and could even be laid down in letters between the parties or in minutes of gatherings, however most treaties are in some way similar to the form of an agreement.[126]

International law has no law making body which can make enactments nor does it have a court system within which these enactments can be enforced. This is different from domestic law where enforcement is possible and a framework of laws are exists.[127]

Both treaties and customs or international trade usage are sources of international law and their functions may overlap to a certain extent, as is indicated by Shaw in showing that treaties can for example repeat the rules and procedures which are observed and made up of customary law.[128]

Treaties are regarded as being written agreements whereby states bind themselves to act in a manner agreed certain type of behavior or to establish rules for behavior in future relations with each other.[129]

Treaties can be divided into treaties which are intended to be of universal application, and those which are to apply to the relations of a determined number of states.

[125] Dugard *International Law a South African Perspective* (2003) 26.
[126] Brownlie *Principles of Public International Law* (2003) 581.
[127] Shaw *International Law* (2008) 70.
[128] Shaw *International Law* (2008) 71.
[129] Shaw *International Law* (2008) 94-93.

Treaties are comparable to contracts in that they create obligations among states which are agreed to abide by.[130]

Contractual treaties, legislative treaties and constitutional treaties exist either in the bilateral form, between two states or in multilateral form, between numerous states. A contractual treaty would govern for example dealings regarding trade or air landing rights. States establish a "legal relationship" in terms of contractual treaties. A legislative treaty is a treaty which concretises rules which already exist through customary international law, but are not binding on the parties to the treaty, and serve mainly as proof of the existence of a generally observed customary rule. A constitutional treaty would typically be a treaty which creates or establishes an international organisation.[131]

Treaties are governed by the Vienna Convention of the Law of Treaties 1969, which regulates the interpretation, termination and processes to be followed when entering into a treaty.[132]

Treaties are seen as being superior to custom and aid the greater need which has arisen for some form of regulation between states as a result of the great developments in technology and communication.[133]

Treaties are terminated by retraction by one of the parties, or where the treaty makes no mention one can argue that it is implied. Other instances are breach of the terms of a treaty or where there is a supervening impossibility to perform or the circumstances in which the conclusion of the treaty took place have drastically changed.[134]

When one regards the nature of a treaty, specifically the intention to be bound to treaties in order to regulate the relations between states, the fact that they are agreements which are signed and assented to, or ratified, creating obligations between

130 Shaw *International Law* (2008) 94.
131 Dugard *International Law a South African Perspective* (2003) 27.
132 Dugard *International Law a South African Perspective* (2003) 26.
133 Shaw *International Law* (2008) 94.
134 Ott *Public International Law in the Modern World* (1987) 43.

them would lead me to conclude that Basel II does not comply with the classification of treaty. States can only be bound by treaties if they have assented to or ratified a treaty, which involves a conscious decision to be bound while creating obligations between states. In my opinion Basel II does not create obligations between states outright, but is rather a general agreement to apply certain standards and principles of best practice within members' respective banking industries.

4.4 *International trade usage*

Due to the fact that international law has no binding judicial system, customs play an important role in international law.[135]

Chapter 14 of the Constitution of The Republic of South Africa is dedicated to the role which international law plays in the South African legal system.[136] Customary international law is regarded as law in South Africa unless it is inconsistent with the Constitution or an act of parliament.[137] The recognition of customary international law in this fashion indicates the reality of customs and trade usage in South African and international law. Provision is also made for international law to play a role in the manner in which courts in South Africa interpret legislation. Legislation should be interpreted in a manner which prefers any reasonable interpretation in line with international law.[138]

Customs are a product of behavior which develop within social groupings and are constantly or to a great extent observed by the members of these social groupings. Customs are normally not solidified by codification in a written set of pronouncements to be followed, but are followed on a continuous basis and evolve together with the social grouping which observes them.[139]

In international law the permission of a state to be bound by a customary rule is implied and observed from the specific state's conduct. The fact that conduct is a

[135] Dugard *International Law a South African Perspective* (2003) 28.
[136] Act 108 of 1996.
[137] See s 232 of Act 108 of 1996.
[138] See s 233 of Act 108 of 1996.
[139] Shaw *International Law* (2008) 72-73.

determining factor within customary international law poses certain problems in terms of proving that a state has consented to a customary rule and therefore the requirements of settled practice and the acceptance of the duty to be bound are required to determine whether a customary rule exists in international law.[140]

A custom could be regarded as being a type of tacit agreement whereby countries or states act in a certain way which in certain circumstances.[141]

In order to conclude whether a custom is observed within a community one looks to indicators, which are embedded in the behavioral patterns of a social group or group which have something in common. In terms of international law, one would look at the behaviour of states.[142]

The development of customary international law is a process which does not take place at once, but is developed over time and as behavior conforms or converges surrounding a specific issue or circumstances eventually forming a custom.[143]

Settled practice or *usus* can be derived from the decisions of courts, legislation, comments by states, diplomatic correspondence and the opinion of national law advisers. The International Court of Justice has expressed that an alleged custom must be "constant and uniform usage" before it will qualify as a custom in terms of international law.[144] Usually there is a requirement that a custom must have been observed for some period of time in order for it can be regarded as a customary rule.[145]

A customary rule cannot be created solely by the presence of a settled practice and there must be a sense of duty that the parties are bound to a certain customary rule and

[140]Dugard *International Law a South African Perspective* (2003) 28.
[141] Evans *International Law* (2006) 121 and 122.
[142]Shaw *International Law* (2008) 73.
[143] Ott *Public International Law in the Modern World* (1987) 13.
[144]Dugard *International Law a South African Perspective* (2003) 28; see also *Columba v Peru* 1950 ICJ 266.
[145]Dugard *International Law a South African Perspective* (2003) 29.

is observed as law. This element of the existence of a customary rule has a definite "mental" element of being bound.[146]

Proving that the parties to an alleged customary rule have the sense of duty to be bound by it, and having regard to the fact that it is to a certain extent a mental element, means that proving the existence thereof is not entirely a simple task.[147]

Shaw is of the opinion that customary law is founded on the actions of various states in terms of certain activities and in particular where these activities are similar, thus creating custom.[148]

Proof of whether a custom exists can be found in various forms, for example diplomatic correspondence, official manuals on legal questions or in a patter of treaties or can be inferred from the recital of a treaty.[149]

The nature of international law accommodates the changing of provisions fairly quickly without having to follow certain prescribed procedures.[150]

Soft law, has the capacity to develop into international custom in the event that it is observed over a certain period of time and is observed as state practice, but until such a time it will exist as a guideline against which states can determine their conduct in respect of certain agreed issues.[151]

Basel II does have evident similarities with the requirements and characteristics of international legal custom. It can be argued that Basel II and the manner in which its principles have been applied throughout the world could meet the requirement of use as it has been observed as the standard and best practice for banking supervision in general and that a certain period of time has elapsed in which the custom has been in

[146] Dugard *International Law a South African Perspective* (2003) 31.
[147] Dugard *International Law a South African Perspective* (2003) 32.
[148] Shaw *International Law* (2008) 74.
[149] Brownlie *Principles of Public International Law* (2003) 6.
[150] Shaw *International Law* (2008) 74.
[151] Dugard *International Law a South African Perspective* (2003) 36.

observance. Further the psychological element of being bound could be seen as the fact that countries, while not being bound thereto, will implement and apply the principles of Basel II in their domestic legal systems and banking industries.

4.5 *Lex Mercatoria*

The *lex mercatoria* has its origins in the early days of commerce and originated during trading activities between merchants from different countries who would over the world adhere to certain practices in doing business with each other. Having its origins in Roman law, the *lex mercatoria* was spread around the world through Rome's conquers, which was characterised by the observance of Roman law as the law which governed international commerce at the time. In this way the *lex mercatoria* became embedded in the regulations which were imposed by the Roman empire. During the middle ages the *lex mercatoria* moved back to being a commercial custom and was eventually introduced into domestic legal systems through nationalism. The twentieth century is characterised by the rapid and significant development of technology and communication and resulted in globalism.[152]

A debate has been conducted for decades as to whether a *lex mercatoria* actually exists. The arguments against the existence of a *lex mercatoria* include that it has no methodical foundation, does not have the required procedural legitimacy, and that domestic legislatures and courts do not actually recognise its existence as well as that it does not have the quality of a of an "autonomous legal system".[153]

Wethmar-Lemmer is of the opinion that the *lex mercatoria* is a constantly changing phenomenon which exists in the international merchant community and that it is an autonomous legal system on its own providing a way in which the changing international world can be managed and regulated.[154] The notion that the *lex*

[152]Wethmar-Lemmer "The Development of the Modern Lex Mercatoria : a Historical Perspective" 2005 *Fundamina* 183 199.
[153]Werthmar-Lemmer "The Debate on the Existence of the Lex Mercatoria" 2006 *Codicillus* 23 36.
[154]Werthmar-Lemmer "The Debate on the Existence of the Lex Mercatoria" 2006 *Codicillus* 38.

mercatoria is not a fully "operative system" and thus cannot function, is dispelled by the introduction of domestic legal rules as residual rules of the *lex mercatoria*.[155]

It makes sense to business people in this century to agree and enter into conventions and laws which are made up of customs which have been developed over time.[156]

Dalhuisen does acknowledge the existence of a new *lex mercatoria* and indicates that it is less "systematic, "less concrete" and embodies a manner of thought which accepts "rules as being guidelines".[157]

With the existence of the *lex mercatoria* since the beginning of trade on an international level, it has been changing constantly in line with commercial developments and movements as well as with the way in which "merchants" have conducted their trade. Trade practices have undergone a phenomenal change since the first existence of the *lex mercatoria*.[158]

Dalhuisen indicates that if it is assumed that an "independent international legal order" exists in terms of which international commercial and financial transactions function it must be established what law will take precedence in this "order" and how it can be found and what the hierarchial structure is of these laws.[159]

Trade practices are embodied in the Uniform Rules of Commerical Practice (here after referred to as the UCP) which applies to letters of credit. The possibility exists that the UCP does not fully incorporate all the trade practices appliccable to letters of credit and must be added to by first explaining the rules in the UCP from their respective systems, by looking at general principles applied in the most significant

[155] Dalhuisen *Dalhuisen Transnational and Comparative Commercial, Financial and Trade Law* (2007) 160.

[156] Wethmar-Lemmer "The Development of the Modern Lex Mercatoria : a Historical Perspective" 2005 *Fundamina* 183 198.
Dalhuisen *Dalhuisen Transnational and Comparative Commercial, Financial and Trade Law (2007) 6.*

[158] Wethmar-Lemmer "The Development of the Modern Lex Mercatoria : a Historical Perspective" 2005 *Fundamina* 183 199.

[159] Dalhuisen *Dalhuisen on Transnational and Comparative Commercial, Financial and Trade Law* (2007) 157.

countries and as a last “resort” referring to domestic laws with reference to the conflict of rules on a discretionary basis only. In Dalhuisen’s opinion this process has the result that domestic laws become a part of the “transnational” *lex mercatoria* and through this process no longer exist as domestic laws.[160]

In my opinion whether Basel II could be regarded as a new *lex mercatoria* requires consideration of the type of commercial dealings which it affects. Basel II is widely observed between banks over the world and certain banks will not do business with each other unless they subscribe to the requirements and principles of Basel II. If bankers are to be regarded as the merchants and Basel II as the trade practice, it could be argued that Basel II does perhaps in its application on such a wide level constitute a new *lex mercatoria*. The principles and recommendations of Basel II have developed over time from the origin of Basel I and have changed and adapted since then.

I do agree with Wethmar Lemmer that the *lex mercatoria* does exist, for the reason that the commercial world have implemented and do observe their own customs in their dealings with one another and that it will exist as phenomenon especially in international law for as long as international trade takes place and for as long as business is done between people on a global level. The existence of a modern *lex mercatoria* can most definitely not be denied, and the making of rules on an international level in light of globalisation has become a reality in the business world today.

I am of the opinion that an argument could be made out for the acceptance of Basel II or even the pronouncements of the Basel Committee to be regarded as a new *lex mercatoria* for the reason that it is a set of rules which are observed widely between bankers within the banking industry and in my opinion can be seen as having developed into a set of rules which bankers abide by not only internally within banks but also in their dealings with other financial institutions.

[160] Dalhuisen *Dalhuisen on International and Comparative Commercial, Financial and Trade Law (2007)* 160 and 161.

4.6 *Comparison between the legal nature of the UCP(Uniform Code of Commercial Practice 600) and Basel II*

While Basel II is an accord which applies to the supervision of banks the UCP applies to and governs the issuing of letters of credit and are formulated by the International Chamber of Commerce.

In international trade payment can be effected in any number of ways, namely by way of an open account, bill of exchange, documentary bill or by way of a letter of credit also known as a documentary credit.[161]

The International Chamber of Commerce aims to encourage international trade, services and investment by removing obstacles which may stand in the way of free flowing commercial transactions and is governed by a constitution.[162]

The UCP is described as "rules" which apply to a documentary credit when it provides in it that it is applicable thereto and are binding on all parties to the letter of credit unless specifically stated that the rules of the UCP are excluded.[163]

A letter of credit is characterised by agreement between a buyer to make payment to a seller through a reliable bank on presentation of documents which are compliant with the terms and conditions of credit advanced. The buyer is referred to as the "applicant" and the seller is referred to as the "beneficiary".[164]

There has been a decline in the observance of the UCP over the years, but it still plays and integral role in international commerce. This decline is ascribed to escalating

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[161]Carr *International Trade Law* 2005 470.

[162]"Constitution of the International Chamber of Commerce "http://www.iccwbo.org/uploadedFiles/ICC/ICC_Home_Page/pages/ICC_Constitution_EN_8_June_2009.pdf (28-11-2010)

[163]International Chamber of Commerce *ICC Uniform Customs and Practice for Documentary Credits 2007 Revision* 2007 17

[164]Carr *International Trade Law* 2005 473.

bank charges, and increase in the rejections of the letters of credit and differing interpretation of the rules in various jurisdictions.[165]

The UCP is a type of convergence on an area of international trade and commerce and from the outset requiring that its rules be enacted into domestic law by these countries.[166] South Africa has not incorporated the rules of the UCP into domestic legislation.[167] In South Africa the parties to a letter of credit can decide whether South African private international law or the rules of the UCP must apply to their relationship, thereby choosing a "legal system" to govern their dealings.[168]

The UCP has been described as rules for documentary credits implemented by "international banking practice and mutual agreement between international bankers".[169]

The UCP has undergone a number of revisions, mostly to bring it in line with developments in various areas of commerce and industries.[170]

The UCP is related to banking law and consequently the International Standard Banking Practice for the Examination of Documents under Documentary credits was formulated incorporating "international standard banking practice".[171]

When one considers the nature of Basel II and that of the UCP 600, the following observations are evident. The Basel Committee is for Basel II what the International Chamber of Commerce is for the UCP 600, and these bodies are entrusted with the task of formulating the rules applicable to these rules or standards. The composition

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[165] "The UCP 600: A New Law Applicable to Documentary Letters of Credit" 2009 *SA Merc LJ* 228 228.
[166] Carr *International Trade Law* 2005 472.
[167] Schulze "The UCP 600: A New Law Applicable to Documentary Letters of Credit" 2009 *SA Merc LJ* 228.
[168] Fredericks and Neels "The Proper Law of Documentary Letter of credit Part 1" *SA Merc LJ* 63 64.
[169] Schulze "The UCP 600: A New Law Applicable to Documentary Letters of Credit" 2009 *SA Merc LJ* 230.
[170] International Chamber of Commerce *ICC Uniform Customs and Practice for Documentary Credits 2007 Revision* 2007 11.
[171] International Chamber of Commerce *International Standard Banking Practice for the Examination of Documents under Documentary credits* 2007 12.

of the Basel Committee is dissimilar to that of the International Chamber of Commerce in that members may be representatives of corporations,[172] and the composition of the Basel Committee is representative of bank supervisor representatives from various member states. Neither the International Chamber of Commerce nor the Basel Committee possesses any law-making authority.

Basel II and the UCP are similar in that compliance with the rules set out therein are not mandatory and are applied on a voluntary basis. A further difference lies in the fact that Basel II is a formulation of best practice on banking supervision for banks as a whole and the UCP is a formulation of rules which govern a specific relationship which exists within a component of banking law and trade. The rules of the UCP and Basel II are both non-binding.

The indication that the rules of the UCP must be incorporated into domestic legislation in order for mandatory compliance is similar to the position under Basel II. The enactment of various provisions of Basel II into domestic legal systems has taken place, as well as in terms of the UCP.

Although there has been a decline in the observance and application of the UCP, the observance and application of the Basel Accords has increased. This may be ascribed to greater pressure placed on banks to comply with the principles of Basel II, as many banks will not do business with banks if they are not compliant or observe the rules of the accord. As set out above there remains a choice as to what “legal system” should apply to a letter of credit.

As with the UCP various revisions have been made to Basel II to keep up with developments.

[172] Constitution of the International Chamber of Commerce “http://www.iccwbo.org/uploadedFiles/ICC/ICC_Home_Page/pages/ICC_Constitution_EN_8_June_2009.pdf (28-11-2010).

4.7 *Conclusion*

In my opinion the only possible classifications which are closely possible to the nature of Basel II are that of being either a new *lex mercatoria* or international trade usage.

The classification of Basel II as a contract is not possible due to no remedies being available in law as well as enforcement of obligations not being possible between members of the Basel Committee.

The debate which surrounds the existence of a *lex mercatoria* is in my opinion not realistic in light of the clear customs which are followed by persons who conduct business with each other on an international level, as well as the fact that various industries choose to maintain a set of rules which they observe internationally in commercial dealings with each other. In my opinion support could be found for the existence of a new *lex mercatoria* within the global banking industry and could be regarded as a possible classification for Basel II.

Classification of Basel II as a treaty seems untenable as obligations are not created between states.

The fact that soft law can develop into custom and trade usage supports an assumption that Basel II could be categorised as such in future, in the event that the requirements for international trade usage are proven and established sufficiently.

The ideal would be that banking supervision would begin with the enforceable regulation of banks on an international level and that these regulations would then trickle down to a national and domestic level.[173]

[173] Hudson *The Law of Finance* (2009) 739.

CHAPTER 5
BASEL II AND THE WORLD ECONOMIC CRISIS

5.1 *Introduction*

The financial crisis which came about in 2007 proved what an integral role banks play in any economy.[174]

The financial crisis originated with the sub-prime housing market collapse and then a loss of confidence in Western banks which lay within global imbalances in trade and capital availability between advanced and emerging economies.[175]

In response to the financial crisis the Basel Committee indicated that it is working towards strengthening the current supervision measures in place under Basel II. In their deliberations as to how Basel II can be strengthened they agreed that development was necessary with regard to capital requirements and the quality of capital which had to be held. The new measures and standards would be known as Basel III, and would result in higher capital and liquidity requirements for banks, less effects of procyclicality and greater resilience of the banking industry to stress factors as were experienced during the financial and banking crisis.[176]

The Basel Committee has expressed its opinion that better regulation is not enough and that the promotion of financial stability requires a broad framework, as well as macroeconomic policies and market discipline. The financial crisis has shown the importance of banking supervision and the implementation of policies of prudential supervision. We must steer clear of the attitude that certain banking institutions are too large to fail and promote adequate risk management and disclosure on all levels. The financial crisis did bring to light a number of shortcomings in relation to the areas of governance, risk management and due diligence which the private sector, in

[174]Berger, Molyneux and Wilson *The Oxford Handbook of Banking* (2010) 38.

[175]Gieve "Europe and the Global Financial Crisis" http://www.ebslondon.ac.uk/default.aspx?page=728 (23-09-2010).

[176]Basel Committee response to financial crisis www.bis.org/bcbs/fincriscomp.htm (20-09-2010).

particular banks, shareholders and investors and other market role players have to address.[177]

Basel II has been criticised as not having prevented the banking crisis of 2008, some are of the opinion that Basel II did not exist for long enough or had not been implemented for long enough in order to have sufficient opportunity to prevent the crisis.[178]

Lessons which could be learned from the economic crisis include closer international co-ordination in terms of macro-economic policy, establishing better rules for cross-boarder financial crises, strengthening the resilience of banks and developing macro-prudential tools.[179]

5.1 *Basel II, the world economic crisis and the United States of America*

The most significant effect or actually the cause of the financial crisis in the United States of America was the sub-prime crisis which came about in relation to sub-prime mortgages. The sub-prime mortgage crisis which was experienced in the United States of America later spilled over to the rest of the world.[180]

The banking crisis in the United States of America had an impact on other countries due to the fact that financial institutions in other countries bought securities which were issued by financial institutions in the United States of America secured by mortgage bonds over properties in the United States of America.[181] Not only were small depositors affected by the sub-prime crisis in the United States of America, but some of the most advanced and largest banks in the world had purchased securities

[177] Caruana "Basel III: Towards a Safer Financial System" http://www.bis.org/speeches/sp100921.htm basel III (23-09-2010).
[178] Hudson *The Law of Finance* (2009) 745.
[179] Gieve "Europe and the Global Financial Crisis" http://www.ebslondon.ac.uk/default.aspx?page=728 (23-09-2010).
[180] Welfens "The International Banking Crisis: Lessons and EU Reforms" http://ec.europa.eu/ education/programmes/llp/jm/more/bru08/ welfens_en.pdfconference (18-09-2010).
[181] Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law* 1 1.

from these banks with the aim of making higher returns and perhaps with inadequate investigation.[182]

A sub-prime mortgage is a mortgage loan to a borrower with insufficient or "sub-standard" security. This type of mortgage loan is usually extended to borrowers who have bad credit records or do not have stable levels of income and would normally not be able to source a loan from a bank. There is compensation for these types of mortgage loans, being an increased cost due to the increased rate of risk which is taken by a lender in advancing the loan in such circumstances.[183]

The increase of defaulting payments of subprime borrowers culminated in the loss of value in terms of mortgage backed assets. Credit risk and liquidity problems caused many large banks to take large "write downs" and eventually led to insolvency and also exposed many companies to risk.[184]

The response of bank regulators in the United States of America to the subprime crises included that a subprime lender must obtain approval from a regulatory authority and they encouraged that banks must rather price their subprime loans in terms of the risk than on the rates that institutions in competition with them are charging.[185]

The fact that banks make use of depositors' funds to invest, and the fact that significant losses were felt on mortgage backed securities, had a great impact of the capital levels of banks, which either resulted in banks being declared insolvent or being unable to lend.

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[182] Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law* 1 2.

[183] Johnston, Greer and Biermacher "The Subprime Morass: Past, Present, and Future" 2008 *N.C. Banking Inst* 125 125.

[184] Johnston, Greer and Biermacher "The Subprime Morass: Past, Present, and Future" 2008 *N.C. Banking Inst* 131-132.

[185] Gilreath "The Entrance of Banks into Subrime Lending : First Union and Money Store" 1999 *N.C. Banking Inst.* 162-164.

The banking and financial crisis became even worse with the bankruptcy of Lehman Brothers and the conflicting decision to save Bear Stearns, which is just a small investment bank in relation Lehman Brothers. The bankruptcy of Lehman Brothers is said to have had a marked impact on the confidence in interbank markets and made clear that no bank in the United States, including the very largest were safe from the financial crisis.[186]

The banking crisis in the United States of America is the most significant and damaging crisis since the Great Depression and without a stable banking system the risk of another Great Depression was considerable.[187]

The financial crisis and the rescues evident during the crisis have raised the query that perhaps financial institutions other than banks should be regulated in a similar fashion to banks.[188]

5.3 *Basel II, the world economic crisis and South Africa*

During the world economic crisis the South African Reserve Bank maintained its objective of ensuring that the domestic banking system in South Africa remained sound by way of efficient compliance with international regulatory and supervisory standards.[189]

The effects of the international economic crisis worsened the environment within which banks had to operate consequently evidencing a decline in the rate of growth in loans and advances by banks and increasing the pressure on consumers. The pressure felt by consumers could be seen in the rise in defaults on loans having an impact on the profits made by banks.[190]

[186] Welfens "The International Banking Crisis: Lessons and EU Reforms" http://ec.europa.eu/ education/programmes/llp/jm/more/bru08/ welfens_en.pdfconference (18-09-2010).
[187] Welfens "The International Banking Crisis: Lessons and EU Reforms" http://ec.europa.eu/ education/programmes/llp/jm/more/bru08/ welfens_en.pdfconference (18-09-2010).
[188] Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law* 1 12.
[189] Mboweni "Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank" http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).
[190] Mboweni "Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank" http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).

The former Governor of the South African Reserve Bank indicated in his address to the annual general meeting of the South African Reserve Bank that despite the world economic crisis, the South African banking system remained stable and that banks were holding adequate levels of capital.[191]

It is evident that South African banks felt the impact of the world economic crisis to some extent with lower levels of lending and increased levels of bad debts. No banks had liquidity problems or required monetary support from authorities. South African banking supervisors and the South African Reserve Bank implemented prudential measures even before the financial crisis manifested. These measures included “fit and proper” assessments and training of executive and non-executive directors, focusing on high quality management of risks in banks and implementing minimum capital requirements which were higher than that prescribed.[192]

The South African Reserve Bank commissioned an independent review of all securitisation schemes in which domestic banks were involved to determine whether prudential management of the schemes was being implemented in response to the world economic crisis, and no material issues were identified during the review.[193]

Prudent regulatory and supervisory networks in South Africa assisted it to weather the financial crisis fairly well.[194] Most of these networks had been put in place in complying with Basel II.

5.4 *Basel II, the world economic crisis and the United Kingdom*

The United Kingdom is identified as one of the countries which has been hit the hardest by the world economic crisis.

[191] Mboweni “Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank” http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).

[192] Elebute and Martin “The Financial Crisis in Africa”www.kpmg.com/Global/en/IssuesAndInsights/...in.../17014.html (20-09-2010).

[193] Mboweni “Governors address at the eighty-ninth AGM of shareholders of the South African Reserve Bank” http://www.info.gov.za/speeches/2009/09091714551002.htm (20-09-2010).

[194] Mminele “Insulating South Africa Against Global Risks – Challenges” http://www.bis.org/review/r100825e.pdf (18-09-2010).

The world economic crisis was characterised by the failure of Northern Rock one of the largest banks in the United Kingdom caused by a run.[195] The run on Northern Rock, was different to the type of run which would normally be expected in that there was no "pattern of coordinated failure". The run which placed Northern Rock into a liquidity crisis was not a run which was specifically aimed at Northern Rock only. Another difference between the normal bank run and that which was experienced by Northern Rock is that the run was not caused by ordinary small depositors, but by major investors in the bank.[196] What is notable is that the run experienced by Northern Rock was not in anticipation of a possible liquidity crisis but came after a liquidity crisis had been identified.[197]

Northern Rock was an institution which was highly geared, and by this reason was more vulnerable to impacts from changing conditions in terms of lending.[198]

Northern Rock made use of short term debts to finance long term assets, which is the usual manner in which banks operate and this makes it difficult for an institution to be properly "hedged".[199]

The global financial crisis was also characterised by bank failures in Europe, showing that the crisis which originated in the United States of America was of a global nature and impacted other countries to a great extent.[200]

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[195] Shin "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" 2009 *Journal of Economic Perspectives* 101 107.

[196] Shin "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" 2009 *Journal of Economic Perspectives* 110.

[197] Shin "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" 2009 *Journal of Economic Perspectives* 102.

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[199] Shin "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" 2009 *Journal of Economic Perspectives* 115.

[200] Speech by Sir John Gieve "Europe and the Global Financial Crisis" http://www.ebslondon.ac.uk/default.aspx?page=728 (23-09-2010).

5.5 *Conclusion*

The fact that average level of capital required by Basel II proved to be inadequate, the cyclicality of the capital requirements in terms of Basel II, the fact that the assessment of credit risk is done by institutions which are not banks (ratings agencies) and the possible conflicts of interests involved therein as well as assuming that the internal models of banks for measuring risks are advanced have been regarded as some of the responsibilities which Basel II had in the recent financial crisis.[201]

In defense of Basel II's alleged contribution to the financial crisis, the implementation of Basel II was postponed in the United States of America to 2010 and only the largest banks in that country will be required to comply therewith. Smaller banks in the Unites States of America can elect whether or not to implement and apply Basel II. The use of Basel II by banks in 2007 was restricted at the time that the financial crisis took place and most banks observed the Capital Requirements Directive of the European Union, implementing Basel II in the European Union, allowing postponement of Basel II implementation until 2008. It is for these reasons the United States of America and European Union felt the impact of the economic crisis under the requirements and principals of Basel I and were not protected by the improved and strengthened principles of Basel II at the time when the crisis manifested. Even though banks were only protected by Basel I in the sense of the financial crisis, many banks had already started readying themselves for implementation of Basel II and had to this end adapted and reviewed their credit processes to prepare themselves for Basel II requirements.[202]

Some authors are of the opinion that Basel II did not have an integral part in the banking and financial crisis, bearing in mind that the regulatory shortcomings during the crisis were rather in relation to Basel I than to Basel II, coupled with the fact that Basel II had largely not yet been implemented in many countries are to be considered before attributing blame to the Basel Committee and Basel II. Basel II could not be

201 Università Commerciale Luigi Bocconi *Carefin Working Paper* (2009) 1 3.

202 Università Commerciale Luigi Bocconi *Carefin Working Paper* (2009) 1.

expected to have curtailed unregulated intermediaries within the investment market or guarded against high gearing and irresponsible assumption of risks.[203]

Various other elements have been identified as contributing factors to the financial crisis namely the rules of liquidity of banks which highlighted sub-standard crisis management between countries as well as the supervision of banks in domestic legal systems or in countries not being efficiently applied.[204]

Defective regulation was only one of the contributing factors to the financial crisis and the impact of the crisis on a global level required that it be dealt with on a macroeconomic level. The G-20 countries attempted to do this but only produced general agreement on certain matters which lacks the backing of permanent staff compliment to continuously work on the points on which the G-20 nations reached agreement.[205]

What is however clear from the shocks and impact of the financial and banking crisis is that Basel II does require strengthening and this has been realised by the Basel Committee in its work on Basel III, mainly aiming at making the banking industry resilient to financial shocks which it could experience.

One of the significant lessons of the world economic crisis in my opinion would be that although certain measures were not adequate in prohibiting the crisis, the focus should be on constantly improving current regulatory frameworks and best practice for the banking industry. The world economic crisis has not affected the great importance of the prudential supervision of banks and the integral role of banking regulators, banking supervisors and international cooperation.

[203]Università Commerciale Luigi Bocconi *Carefin Working Paper* (2009) 15.
[204]Università Commerciale Luigi Bocconi *Carefin Working Paper* (2009) 15.
[205]Dam "The Subprime Crisis and Financial Regulation: International and Comparative Perspectives" 2010 *Chicago Journal of International Law*1 56; G-20 is the group of twenty finance ministers and central bank governors from industrialised nations who discuss key issues in the global economy.

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